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Margaret Barr Bruemmer

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# PROXY SOLICITATIONS: THE NEED FOR EXPANDED DISCLOSURE REQUIREMENTS

## I. INTRODUCTION

Corporate shareholders have a proprietary interest with respect to the earnings, net assets, and control of the corporation.<sup>1</sup> Although the board of directors is generally responsible for the determination and execution of corporate policy,<sup>2</sup> certain decisions must be made by the shareholders. The ambit of shareholder control includes the election and removal of directors, ratification of actions taken by the board of directors, the adoption, amendment and repeal of by-laws, shareholder resolutions and extraordinary corporate matters.<sup>3</sup> These decision-making powers are exercised either by voting in person or by proxy<sup>4</sup> at shareholder meetings. Today, however, proxy voting is the dominant method of shareholder decision-making in publicly held corporations.<sup>5</sup> The proxy process is a useful device, but in its operation it tends to favor management rather than the shareholders.<sup>6</sup> Because it can be manipulated by management in ways which effectively deprive the shareholders of their franchise, proxy voting should be strictly regulated.

Proxy voting is preferable to physical attendance at a shareholders' meeting simply because it is more economical and convenient for the typical individual shareholder. Shareholders are often geographically dispersed, making attendance at the meeting expensive and inconvenient.<sup>7</sup> Most individual shareholders, as opposed to institutional investors, are engaged in a principal business other than investing and lack the time or opportunity to attend the meeting.<sup>8</sup> Also, even if a shareholder

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1. H. HENN, *HANDBOOK OF THE LAW OF CORPORATIONS* § 157 (2d ed. 1970) [hereinafter cited as HENN].

2. *Id.* § 207.

3. *Id.* § 188.

4. "The term 'proxy' is a contraction of 'procuracy' which means, among other things, the act of officiating as an agent for another." N. LATTIN, *THE LAW OF CORPORATIONS* § 90 n. 80 (2d ed. 1971) [hereinafter cited as LATTIN].

5. Eisenberg, *Access to the Corporate Proxy Machinery*, 83 HARV. L. REV. 1489, 1490 (1970) [hereinafter cited as Eisenberg].

6. LATTIN, *supra* note 4, § 90.

7. Eisenberg, *supra* note 5. See F. EMERSON & F. LATCHAM, *SHAREHOLDER DEMOCRACY* 14-15 (1954).

8. Eisenberg, *supra* note 5. For an analysis of shareholder expectations of participation in corporate decisionmaking, see Eisenberg, *The Legal Roles of Shareholders and*

were to support or oppose certain matters slated for resolution, he may not wish to speak on the issues at the meeting, but may wish only to vote. In light of the disadvantages of physical attendance, it is understandable that shareholders favor proxy representation.

Proxy voting was not permitted at common law,<sup>9</sup> but out of necessity, modern corporate practice has evolved to the point where all fifty states now permit it.<sup>10</sup> The reasons for this evolution include the increase in both the size of corporations and the number of shareholders, the separation of ownership and management, and the resultant widespread distribution of corporate securities.<sup>11</sup> In the modern corporation "the entire concept of the shareholders' meeting [is] at the mercy of the proxy instrument."<sup>12</sup>

The proxy relationship is commonly defined as the agency created when a corporate shareholder authorizes the proxy holder to represent him at the shareholder meeting by casting the votes to which the shareholder is entitled by virtue of his stock ownership.<sup>13</sup> The term "proxy" has traditionally been used in several different contexts: the authority the shareholder gives to his agent; the person appointed by the shareholder (called the proxy holder); the instrument in which such appointment is embodied; and the agent's exercise of the authority.<sup>14</sup> In most agency relationships the principal instructs the agent. The agent holding a corporate proxy, however, usually has at his disposal more information relating to the issues involved than does his principal, and therefore it is the agent who determines the matter for which the agency will be created as well as the manner in which it will be carried out.

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*Management in Modern Corporate Decisionmaking*, 57 CALIF. L. REV. 1 (1969).

9. Axe, *Corporate Proxies*, 41 MICH. L. REV. 38 (1942). This article, in conjunction with Axe, *Corporate Proxies: II*, 41 MICH. L. REV. 225 (1942), gives a general history of the law of proxies.

10. See 2 L. LOSS, *SECURITIES REGULATION*, at 857-58 n.1 (2d ed. 1961 & Supp. 1969) and 5 L. LOSS, *SECURITIES REGULATION*, at 2829-30 (2d ed. 1961 & Supp. 1969) [hereinafter cited as 2 Loss or 5 Loss, respectively].

11. 1 L. LOSS, *SECURITIES REGULATION*, at 8-19 (2d ed. 1961 & Supp. 1969) [hereinafter cited as 1 Loss]. See also A. BERLE & G. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

12. 2 Loss, *supra* note 10, at 858.

13. W. FLETCHER, *CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* § 2050 (rev. perm. ed. 1975).

14. HENN, *supra* note 1, § 196.

This distortion of the typical principal-agent relationship is inherent in the present day corporate structure and makes possible many abuses of the proxy voting system.<sup>15</sup> A common complaint is that the proxy system has often been abused by corporate management who have used it "to perpetuate itself in office, to formulate and execute self-serving policies, and to render the corporation subservient to its will."<sup>16</sup> Such consequences often result when directors and officers withhold from the stockholders the type of information necessary for shareholders to vote their proxies intelligently.

The natural prerequisite of proxy voting is proxy solicitation, the process whereby shareholders are systematically contacted and advised to execute and return proxy cards which authorize named proxies to cast the shareholder's votes either in the manner indicated on the proxy card or at the proxy's discretion. Since the purpose of the proxy instrument is to facilitate the intelligent exercise of the stockholder's franchise, the proxy solicitation process must fully and fairly inform the shareholder of management policies and actions as well as make available an instrument by which he can effectively express his personal judgments.<sup>17</sup> In addition to facilitating intelligent voting by the stockholder, the proxy instrument should also provide a means for a shareholder to present his proposals to the other shareholders for approval or disapproval.<sup>18</sup>

The key to the effective enfranchisement of shareholders is adequate disclosure in the proxy solicitation process—providing the shareholder with the necessary facts to enable him to make an intelligent decision on whether to grant his proxy.<sup>19</sup> Inadequate disclosure can occur in a number of ways. Partial disclosure, probably the most common and most difficult to control, occurs when a stockholder is provided with some information, but not enough to make a prudent choice.<sup>20</sup> Misrepresentation is another form of inadequate disclosure whereby fraudulent and misleading statements are made to

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15. von Mehren & McCarroll, *The Proxy Rules: A Case Study in the Administrative Process*, 29 L. & CONTEMP. PROB. 728 (1964).

16. E. ARANOW & H. EINHORN, *PROXY CONTESTS FOR CORPORATE CONTROL* at 89 (2d ed. 1968) [hereinafter cited as ARANOW & EINHORN].

17. *Id.* at 90.

18. *Id.*

19. *Id.*

20. Comment, 1960 DUKE L.J. 623, 630 n. 28 [hereinafter cited as DUKE L.J.].

deceive the shareholder into giving his proxy.<sup>21</sup> Finally, there is the deliberate omission of information, which if given, is likely to keep the shareholder from returning his proxy.<sup>22</sup>

Congress has attempted to remedy the abuse of the proxy solicitation process with regulations issued by the Securities and Exchange Commission under section 14 of the Securities Exchange Act of 1934.<sup>23</sup> State law, however, is a virtual void in this respect. Most state laws do not even recognize the existence of proxy solicitation.<sup>24</sup> Needless to say, where there is no recognition, there can be no regulation of abuse. In addition, case law has failed to close the gap left by the state legislatures.

The common law has long recognized the right of a shareholder to bring an action based on the fraudulent or deceitful solicitation of a shareholder's proxy,<sup>25</sup> but the courts have defined adequate disclosure in the proxy solicitation process in only a very vague and general way. In contrast to the states, the federal government has met the problem head-on with the Proxy Rules promulgated and administered by the Securities and Exchange Commission (hereinafter SEC or Commission).<sup>26</sup> The presence of federal rules and a central administrative mechanism for enforcing them may account in part for the inaction of state legislatures in this particular area. The Proxy Rules, however, are not extensive enough. They do not regulate the proxy solicitations of all public corporations, but only those whose securities are either listed on a national exchange or are equity securities issued by a corporation with assets of more than one million dollars and held by 500 or more shareholders.<sup>27</sup>

The problem of protecting shareholders of publicly held corporations not within the SEC's jurisdiction by providing them with adequate disclosure in the proxy solicitation process remains to be resolved. This comment will examine both the federal and state approaches to the problem of adequate disclosure in the proxy solicitation process and submit recommendations that would provide for greater investor protection.

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21. *Id.*

22. *Id.*

23. 15 U.S.C. § 78n(a) (1970).

24. DUKE L.J. *supra* note 20, at 636.

25. *See, e.g.,* ARANOW & EINHORN, *supra* note 16, at 520.

26. 17 C.F.R. § 240.14a *et seq.* (1976).

27. 15 U.S.C. § 78l(g)(1) (1970).

## II. THE FEDERAL APPROACH AND THE EVOLUTION OF THE PROXY RULES

The statutory basis for federal regulation of proxy solicitations is section 14(a) of the Securities Exchange Act of 1934.<sup>28</sup> The congressional hearings that led to the passage of this act identified serious abuses in the prevailing proxy solicitation practices.

Fair corporate suffrage is an important right that should attach to every security bought on a public exchange. Managements of properties owned by the investing public should not be permitted to perpetuate themselves by the misuse of corporate proxies, insiders having little or no substantial interest in the properties they manage have often retained their control without an adequate explanation of the management policies they tend to pursue.<sup>29</sup>

Recognizing that a regulatory device for the corporate proxy system would necessarily be technical and complex, Congress abandoned the more specific standards of the original bills and delegated very broad powers to the Securities and Exchange Commission.<sup>30</sup> The only standards provided in the enabling legislation were those inherent in such terms as "public interest" and "protection of investors." Neither the form nor the substance of the regulatory scheme was prescribed. Rather, the entire problem of the nature and scope of federal proxy regulation was left to the Commission to resolve. The Proxy Rules as they have evolved since first published in 1935 represent the Commission's exercise of this delegated duty. They demonstrate a progressive expansion of federal control over the proxy solicitation process by means of increasingly precise regulations. The rules promulgated under section 14 are principally designed to assure that shareholders are informed of those facts regarding the resolutions to be considered at the share-

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28. 15 U.S.C. § 78n(a) (1970) reads as follows:

It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to section 78l of this title.

29. H.R. REP. NO. 1383, 73d Cong., 2d Sess. 13-14 (1934).

30. The Commission was established by § 4(a) of the Act, 15 U.S.C. § 78d (1970).

holders' meeting for which the proxy is solicited in order to enable the shareholder to exercise his vote intelligently.<sup>31</sup>

The SEC published its first set of Proxy Rules, known as the "LA Rules," on September 24, 1935.<sup>32</sup> These seven rules were so rudimentary, experimental, and inadequate that they were hardly regulatory. They required the issuance of a proxy statement containing a brief description of the matters to be considered at the forthcoming shareholders' meeting, prohibited false or misleading statements, required the filing of proxy materials at the time they were mailed to stockholders, and required management to mail out any proxy materials that were submitted by shareholders. These rules were adopted as an interim measure in spite of their inadequacies in order to prohibit the circulation of false information.<sup>33</sup>

It was readily apparent after only a few years that the LA Rules failed to compel the amount of disclosure necessary to make proxy solicitation effective. In some cases information was furnished to stockholders on the back of a postcard.<sup>34</sup> The rules were therefore revised in 1938 and published as Regula-

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31. Professor Louis Loss has commented on the usefulness of the proxy rules:

The proxy rules are very likely the most effective device in the SEC scheme of things. The proxy literature, unlike the application for registration and the statutory reports, gets into the hand of investors. Unlike the Securities Act prospectus, it gets there in time. It is more readable than any of these other documents. And it gets to a good many people who never see a prospectus. . . .

2 Loss, *supra* note 10, at 1027. Manuel F. Cohen, a former chairman of the Commission has said:

The primary underlying concept of the proxy rule—consistent with the philosophy of the statute—is that of disclosure. While the proxy regulation contains procedural rules of one kind or another, these are designed in the main to make effective the basic requirements and to permit freer communication among security holders.

Cohen, *The SEC and Proxy Contests*, 20 FED. BAR J. 91, 98 (1960).

32. Sec. Exch. Act Rel. No. 378 (Class A), (Sept. 24, 1935) (Regulation LA), discussed in Aranow & Einhorn, *Proxy Regulation: Suggested Improvements*, 28 GEO. WASH. L. REV. 307, 309 (1959).

33. *Securities and Exchange Commission Proxy Rules, Hearings on H.R. 1493, 1821, and H.R. 2019 Before the House Committee on Interstate and Foreign Commerce*, 78th Cong. 1st Sess., pt. I, 14-15 (1943) (testimony of Chairman Purcell):

Now, of course, the Commission knew that these rules would not give adequate information to stockholders. It adopted the rules merely as a means of finding out what types of information should be required in complying with the congressional direction and also in the interim to prohibit false information from being circulated to stockholders. It anticipated that later it would be able to adopt affirmative rules of the type that Congress had in mind.

34. *Id.* at 15.

tion X-14.<sup>35</sup> This regulation, although amended several times, remained in effect until the adoption of the Securities Acts Amendments of 1964.<sup>36</sup>

The applicability of the Proxy Rules is, of course, limited by the enabling legislation as well as by the rules themselves. Prior to 1964, the Proxy Rules applied only to securities (other than exempt securities)<sup>37</sup> that were registered on any national securities exchange and, pursuant to other statutes, to proxy solicitations involving public utility holding companies and registered investment companies. Thus, prior to 1964, if the corporation involved was not listed on a national exchange, a registered investment company, a public utility holding company, or if it had been given unlisted trading privileges on an exchange, the SEC rules were inapplicable. As a result, approximately one-half of the larger corporations in the United States were not within the scope of the SEC's jurisdiction.<sup>38</sup> Since the thrust of the rules was the protection of investors by the regulation of proxy solicitations, many commentators criticized the limited applicability of the rules.<sup>39</sup>

In view of these limitations, the SEC conducted three studies; two examined the proxy solicitation practices of unregistered companies,<sup>40</sup> while the other investigated the securities markets.<sup>41</sup> The abuses of the proxy system discovered by these studies prompted the Securities Acts Amendments of 1964, "the most significant statutory advance in federal securities regulation and investor protection since 1940."<sup>42</sup> While the

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35. Sec. Exch. Act Rel. No. 1823 (Aug. 11, 1938).

36. Act of Aug. 20, 1964, Pub. L. No. 88-467, 78 Stat. 565.

37. Exempt securities include securities listed on national exchanges, securities of registered investment companies, securities of savings and loan associations, non-profit corporations, agricultural cooperatives, and other types of cooperatives. 15 U.S.C. § 78l(g)(2) (1970). U.S., state, and other governmental issues are generally exempt from all federal regulations under 15 U.S.C. § 78c(a)(12) (1970).

38. Bayne, *Around and Beyond the SEC—the Disenfranchised Stockholder*, 26 IND. L.J. 207, 223 (1951).

39. See Aranow & Einhorn, *Proxy Regulation: Suggested Improvements*, 28 GEO. WASH. L. REV. 306 (1959); Brey, *A Synopsis of the Proxy Rules*, 26 CINN. L. REV. 58 (1957); Emerson & Latcham, *SEC Proxy Regulation: Steps Toward More Effective Stockholder Participation*, 59 YALE L.J. 635 (1950); Friedman, *SEC Regulation of Corporate Proxies*, 63 HARV. L. REV. 796 (1950).

40. SEC, A PROPOSAL TO SAFEGUARD INVESTORS IN UNREGISTERED SECURITIES (1946); SEC, A PROPOSAL TO SAFEGUARD INVESTORS IN UNREGISTERED SECURITIES (1950).

41. SEC, Report of Special Study of Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess. (1963).

42. Sec. Act Rel. No. 4725 and Sec. Exch. Act Rel. No. 7425 (Sept. 15, 1964). The



scope of the amendments extend far beyond mere corporate proxy regulation, the key provision regarding proxy regulation is section 12. This section expands the proxy solicitation requirements of the Securities Exchange Act to include corporations involved in interstate commerce or in a business affecting interstate commerce having total assets in excess of one million dollars and a class of equity security held of record by 750 or more persons (after July 1, 1966, by 500 or more persons).<sup>43</sup>

Today, the federal securities legislation regarding the proxy solicitation process is contained in twelve rules and two schedules in section 14a.<sup>44</sup> These regulations detail precisely the form and contents of the proxy, the informational materials which must be supplied to the shareholder, as well as the timetable for providing them. The effect of these rules is to assure that the shareholders receive full and accurate information concerning both the affairs of the corporation and of its officers.<sup>45</sup> The Commission has designed the rules in such a manner as to make the proxy device the closest practicable substitute for attendance at the shareholder meeting. As comprehensive as these rules may be, however, they still fail to govern the substantial number of small publicly held corporations having assets up to one million dollars and up to 500 stockholders. In 1971, there were 1,622,000 corporations with less than one million dollars in assets and it can be estimated that today there are an additional 250,000 corporations in this category.<sup>46</sup>

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Proxy Rules have been referred to as "the salvation of our modern corporate system." A Bill to Amend the Securities Exchange Act of 1934, Hearings on S. 2408, 81st Cong., 2d Sess. 21 (1950).

43. 15 U.S.C. § 78l(g)(1) (1970).

44. The rules are found in 17 C.F.R. §§ 240.14a-1 to 14a-12 (1976); the schedules appear at 17 C.F.R. §§ 14a-101 and 14c-101 (1976).

45. For a discussion of the remedies available for violations of the proxy rules, see ARANOW & EINHORN, *supra* note 16, at 449-540.

46. The number of corporations in this category is difficult to estimate, but an examination of corporate income tax returns statistics indicates that thousands of active corporations have less than one million dollars in assets and, therefore, are not subject to SEC regulation under 15 U.S.C. § 78l(1) (1970). I.R.S., STATISTICS OF INCOME—1971 CORPORATION INCOME TAX RETURNS, at 3, table C (1975); I.R.S., STATISTICS OF INCOME—1970 CORPORATION INCOME TAX RETURNS, at 3, table C (1974); I.R.S., STATISTICS OF INCOME—1969 CORPORATION INCOME TAX RETURNS, at 3, table C (1973); I.R.S., STATISTICS OF INCOME—1968 CORPORATION INCOME TAX RETURNS, at 3, table D (1972); I.R.S., STATISTICS OF INCOME—1967 CORPORATION INCOME TAX RETURNS, at 4, table C (1971); I.R.S., STATISTICS OF INCOME—1966 CORPORATION INCOME TAX RETURNS, at 2, table 1.3 (1970). There are no such statistics available as yet for the years 1971 to 1976, but the computations in Figure 1 make it possible to derive an approximation of the present number of corporations having less than one million dollars in assets.

Figure 1  
Computation of Total Increase for Period 1967-1971 of  
Corporations with Less than One Million Dollars in Assets

Year	Number of Corporations with less than \$One Million in Assets	Incremental Increase Per Year
1966	1,379,000	---
1967	1,442,000	63,000
1968	1,443,000	1,000
1969	1,549,000	106,000
1970	1,559,000	10,000
1971	1,627,000	68,000
		248,000 Total Increase for five years

Assuming there was approximately the same total increase of 248,000 for the years 1971 to 1976 this would result in approximately 1,870,000 corporations in this category at the close of 1976.

It should be evident that both the asset and security holder tests are subject to manipulation. Many assets are "notoriously incapable of exact valuation," and many shareholders are listed under the "street name" designation of a broker rather than in the names of the individual shareholders.<sup>47</sup> This flexibility enables borderline corporations to evade the Commission's regulations. Combine with this flexibility the many corporations that are clearly outside the SEC's jurisdiction and the possibilities for abuse and the need for expanded regulation are obvious.

### III. THE STATE APPROACH

The state legislatures have done nothing either to regulate this system or to provide for standards of adequate disclosure to shareholders. Every jurisdiction's corporate statutes authorize the use of the proxy, but for the most part these laws deal only with the form, sufficiency, and revocability of the proxy.<sup>48</sup> The statutes are silent on the issue of disclosure.

Two states, California and Oklahoma, have broken the silence by enacting legislation dealing with the problem of adequate disclosure. Their statutes, however, deal only with proxy voting on amendments to the articles of incorporation.<sup>49</sup> The

47. ARANOW & EINHORN, *supra* note 16, at 95 n.33.

48. See 2 LOSS, *supra* note 10, at 858.

49. OKLA. STAT. ANN. tit. 18, § 1.154e (West 1971); CAL. CORP. CODE ANN. § 3637 (West 1955) and § 25148 (West Supp. 1976). Section 25148 authorizes the California Commissioner of Corporations to require a proxy statement in certain cases either by rule or order.

only information that must be provided to shareholders is a concise summary of the proposed amendment and the effect it will have on shareholder rights. Failure to comply with the statutory requirements, however, does not invalidate the amendment.

Blue sky regulations, which govern securities transactions within each state, are also silent on the issue.<sup>50</sup> In the past the blue sky laws of the various states differed considerably, but they all failed to regulate the proxy solicitation process. State securities regulations have become increasingly more uniform since the adoption of the Uniform Securities Act in 1956 which was designed to cover transactions "relating to securities; prohibiting fraudulent practices in relation thereto; requiring the registration of broker-dealers, agents, investment advisors, and securities; and making uniform the law with reference thereto . . ."<sup>51</sup> However, the Act still does not regulate the solicitation process.<sup>52</sup> Thus, although the Act has been adopted (or at least substantially adopted with modifications) in thirty-four jurisdictions,<sup>53</sup> it has resulted merely in a system of state securities regulation which uniformly overlooks the protection of investors once they have purchased their securities and attempt to exercise their franchise.

The only disclosure protection most states do provide for investors is that afforded to shareholders of insurance companies. These companies have traditionally been regulated by the individual states, since the business of insurance has long been regarded as not involved in interstate commerce.<sup>54</sup> Unless their

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50. See generally 1 Loss, *supra* note 10, at 32-34.

51. 1 BLUE SKY L. REP. (CCH) ¶ 4901.

52. The Uniform Securities Act is divided into four parts:

The first three parts represent the three basic "blue sky" philosophies: (I) the "fraud" approach, (II) registration of broker-dealers, agents, and investment advisors, and (III) registration of securities. Part IV contains those general provisions (definitions, exemptions, judicial review, investigatory, injunctive and criminal provisions, etc.) which are essential in varying degrees under any of the three basic philosophies.

*Id.* For a discussion of the various types of blue sky philosophies, see 1 Loss, *supra* note 11, at 33-34.

53. Alabama, Alaska, Arkansas, Colorado, Delaware, District of Columbia, Hawaii, Idaho, Indiana, Iowa, Kansas, Kentucky, Maryland, Massachusetts, Michigan, Minnesota, Missouri, Montana, Nebraska, Nevada, New Jersey, New Mexico, North Carolina, Oklahoma, Oregon, Pennsylvania, Puerto Rico, South Carolina, Utah, Virginia, Washington, West Virginia, Wisconsin, Wyoming.

54. *Paul v. Virginia*, 8 Wall 163 (1869), overruled in *U.S. v. South-Eastern Under-*

stock is registered on a national stock exchange or if the company voluntarily registers under section 12 of the Securities Exchange Act of 1934, insurance companies are exempt from SEC rules.<sup>55</sup> However, in order for the insurance company to qualify for such exemption, "[t]he solicitation of the company's proxies must be regulated in accordance with the norms prescribed by the National Association of Insurance Commissioners."<sup>56</sup> The norms provided by the Insurance Commissioners provide for adequate and timely disclosure of those matters with respect to which the proxy is solicited, as well as the general requirements as to the form and content of the proxy.<sup>57</sup> In order to permit domiciled insurance companies to qualify for exemption most states now regulate the proxy solicitation process of these companies either by statute or by statutorily authorized rules issued by the commission of insurance.<sup>58</sup>

In suits brought by aggrieved shareholders seeking an injunction, a writ of mandamus or a writ of quo warranto, state courts have been reluctant to examine the adequacy of disclosure in proxy solicitation. This "judicial passivity"<sup>59</sup> amounts to disenfranchisement of stockholders who rely upon proxy representation as their only means of participating in the affairs of the corporation. Corporate management welcomes the judiciary's laissez-faire attitude. Management views disclosure requirements as an imposition and therefore, quite understandably, declines to voluntarily assume the burden of adequate disclosure.<sup>60</sup> Unless shareholders are fully and fairly in-

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writers Ass'n, 332 U.S. 533 (1944), which held that an insurance company that conducts a substantial part of its business across state lines is engaged in interstate commerce and is subject to regulation by Congress under the commerce clause. *But see* 15 U.S.C. §§ 1011-15 (1970) adopted in 1945, which restored to the states the power to regulate the insurance business that may have been lost by the decision in *U.S. v. South-Eastern Underwriters Ass'n*.

55. 15 U.S.C. § 78l(g)(2)(G) (1970).

56. *Id.* at (ii). The other two requirements are: (1) The corporation must file with the appropriate state official(s) annual reports substantially complying with the forms prescribed by the National Association of Insurance Commissioners, 15 U.S.C. § 78l(g)(2)(G)(i) (1970); and (2) The purchase and sale of the corporation's securities by insiders is subject to regulations which are substantially identical with Section 16 of the Exchange Act. 15 U.S.C. § 78l(g)(2)(G)(i) (1970).

57. Compare 17 C.F.R. 240.14a-1 to 12 (1976) with any state's proxy solicitation rules for insurance companies, e.g., Wis. ADM. CODE Section Ins. 6.40 (1976).

58. See 5 Loss, *supra* note 10, at 2752-53.

59. DUKE L.J., *supra* note 20, at 623-24. This passivity also results in a scarcity of case law on the subject.

60. *Id.* at 633.

formed of the policies of the soliciting group, the right to express their opinions at shareholder meetings is effectively lost.

In those relatively rare cases where the courts do rule on the adequacy of disclosure, they repeatedly fail to set forth and explain the standards upon which their decision rests, but rely instead on vague catchall phrases.<sup>61</sup> The absence of judicial standards causes a lack of consistency and uniformity not only among the various states but within the states as well. This inconsistency is illustrated by two New York cases, *In re Scheuer*<sup>62</sup> and *Matter of R. Hoe & Co.*<sup>63</sup> Both cases involved misrepresentation in the solicitation of proxies. The *Scheuer* court found "deviations from the exacting standards of fairness now generally agreed as incumbent upon those engaged in securing proxies."<sup>64</sup> The court failed, however, to delineate those "exacting standards." The *Hoe* court, on the other hand, refused to impose any such exacting standard. In fact, the court declared that "a certain amount of innuendo, misstatement, exaggeration and puffing must be allowed as a natural by-product of a bitter proxy campaign."<sup>65</sup> The court refused relief, announcing that it would not disturb the action taken by shareholders unless it was clearly established that the solicitation was so tainted with fraud as to accomplish an inequitable result.

Other New York cases have relied on this same standard. That is, the solicitation must be so tainted with fraud that an inequitable result is accomplished, or in the alternative, the misrepresentation must affect the result of the election.<sup>66</sup> Both standards are much too broad to be helpful and create further confusion and inconsistency.

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61. For example, in *Wyatt v. Armstrong*, 186 Misc. 216, 59 N.Y.S.2d 502 (1945), the court declared that it would set aside a corporate election if it found that the methods used to solicit the proxies were "so clouded with doubt and tainted with questionable circumstances that the standards of fair dealing" had been violated. *Id.* at 220, 59 N.Y.S.2d at 505. The court, however, did not delineate what these standards were. It merely concluded that the shareholders were deprived of their freedom to vote at corporate elections after full disclosure of all relevant facts. *Id.* at 224, 59 N.Y.S.2d at 508. This case fails to provide proxy solicitors with any workable standards of disclosure.

62. 59 N.Y.S.2d 500 (1942).

63. 14 Misc. 2d 500, 137 N.Y.S.2d 142 (1954), *aff'd mem.* 285 App. Div. 927, 139 N.Y.S.2d 883, *aff'd mem.*, 309 N.Y. 719, 128 N.E.2d 420 (1955).

64. 59 N.Y.S.2d at 501.

65. 14 Misc. 2d at 505, 137 N.Y.S.2d at 147-48.

66. *Dal-Tran Service Co. v. Fifth Ave. Coach Lines, Inc.*, 14 App. Div. 2d 349, 220 N.Y.S.2d 549 (1961). *See also* *Skora v. Great Sweet Grass Oils Ltd.*, 30 Misc. 2d 572,

The Delaware Court of Chancery adopted a vague test of adequate disclosure based on whether an omission or misrepresentation in a proxy solicitation was material. *Empire Southern Gas Co. v. Gray*<sup>67</sup> relied on this material misrepresentation test. In *Empire* the solicitation data was signed "By Authority of the Board of Directors," when in fact there was no such authority. The court held that the misrepresentation was material and invalidated the election. In *Kaufman v. Shoenburg*<sup>68</sup> the issue was the materiality of the officers' failure to advise stockholders of an existing incentive compensation plan when soliciting proxies regarding the adoption of a similar plan in which the officers would have participated. The court found that it was not a material omission because some reference was made to "additional compensation" received by the directors. The court's language, however, indicated that the omission of material information when soliciting proxies would be cause to invalidate the proxy. Thus, while Delaware protects shareholders from material omissions and misrepresentations, it does little to protect the shareholder from those soliciting groups who simply provide too little information.

The state courts have not only failed to supply workable minimum standards of disclosure, but in addition have not appropriated existing federal standards.<sup>69</sup> On the whole, they have treated the SEC rules as exclusively federal in application. A number of cases have held that a state court has no jurisdiction to hear or determine alleged violations of the Proxy Rules.<sup>70</sup> The basis for these holdings is the language of section 27 of the Act: "The district courts of the United States . . . shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder."<sup>71</sup>

Illustrative of this attitude is *American Hardware Corporation v. Savage Arms Corporation*.<sup>72</sup> The issue in this case was

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205 N.Y.S.2d 98 (1960) (applying the law of Ontario, Canada).

67. 29 Del. Ch. 95, \_\_\_, 46 A.2d 741, 744 (1946).

68. 33 Del. Ch. 211, 91 A.2d 786 (1952).

69. For a review of disclosure requirements in the state courts, see DUKE L.J., *supra* note 12; Aranow & Einhorn, *State Court Review of Corporate Elections*, 56 COLUM. L. REV. 155 (1956).

70. See, e.g., *Standard Power & Light Corp. v. Investment Assoc.*, 29 Del. Ch. 225, 51 A.2d 572, 579 (1947), *aff'g*, 29 Del. Ch. 225, 48 A.2d 501 (1946); *Eliasberg v. Standard Oil Co.*, 23 N.J. Super. 431, 92 A.2d 862, 869 (1952), *aff'd*, 12 N.J. 467, 97 A.2d 437 (1953).

71. 15 U.S.C. § 78a (1970).

72. 37 Del. Ch. 59, 136 A.2d 690 (1957).

whether the proxy statement complied with the SEC Proxy rules, and whether, as a matter of state law, the proxy statement was false or misleading. The Delaware court, however, declined to invade the exclusive jurisdiction of the SEC and the federal courts: "Whether or not there has been noncompliance with the Proxy Rules of the Commission is an issue to be determined solely by the Commission itself and the Federal Courts. The Courts of this state will not assume to trespass upon their exclusive jurisdiction."<sup>73</sup>

The courts have generally avoided the issue of whether the SEC's rules and regulations could or should be used for evaluating the proxy solicitation processes of non-SEC regulated corporations. *Carter v. Portland General Electric Co.*<sup>74</sup> demonstrates the less than hospitable reception that the federal proxy rules have received from the state courts. Although the corporation involved in *Carter* was not subject to the SEC regulations, the Oregon Supreme Court was asked to adopt judicially the federal proxy rules and to apply them to any corporate dispute that was covered by state rather than federal law. The court refused to adopt the SEC rules claiming that such action was appropriate only for the legislature.

In *O'Conner v. Fergang*<sup>75</sup> the New York court implied that if the occasion presented itself, the SEC's Proxy Rules would be considered as the standard for adequate disclosure in a non-SEC regulated proxy battle. One year later, the issue was directly presented in *Bresnick v. Home Title Guaranty Co.*,<sup>76</sup> in which the plaintiff contended that the proxies were "improperly, unfairly and illegally" obtained.<sup>77</sup> The district court applying New York law, was urged to follow the SEC rules even though the securities involved were unlisted, but this suggestion was rejected by the court. Instead, it dismissed the SEC rules as "technical," claiming that "the test is not compliance with the technical rules, but rather whether the proxy-soliciting material was so tainted with fraud that an inequity-

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73. 136 A.2d at 693.

74. 227 Or. 401, \_\_\_, 362 P.2d 766, 769 (1961).

75. 14 Misc. 2d 1095, 1097, 182 N.Y.S.2d 942, 943-44 (1958), wherein the court stated: "Be it noted that in this case the notices and proceedings were not subject to the Securities and Exchange Commission Regulations. But even accepting such standards, the communications here do not vary substantially from other proxy battles under S.E.C. Regulations."

76. 175 F. Supp. 723 (S.D. N.Y. 1959).

77. *Id.* at 724.

ble result was accomplished."<sup>78</sup>

One notable exception to the general refusal of state and federal courts to use SEC standards when evaluating proxy solicitations of corporations not governed by the SEC is *Stockholders Committee For Better Management of Erie Technological Products, Inc. v. Erie Technological Products, Inc.*<sup>79</sup> In this 1965 case the federal district court relied on the SEC Proxy Rules, but did so recognizing that the corporation would soon be subject to the SEC's administration pursuant to the 1964 amendments to the Securities Exchange Act of 1934.

In sum, while the courts have provided relief for individual stockholders, they have failed to provide workable standards to protect stockholders as a class.

#### IV. RECOMMENDATIONS

The foregoing analysis demonstrates the failure to realize the original congressional goal of uniform investor protection. Too many shareholders in small publicly held corporations outside the scope of the SEC regulation are not given adequate protection against misleading proxy solicitation. To guarantee stockholders the necessary information required for the intelligent exercise of their franchise, it is necessary to establish minimum disclosure requirements. These standards can be provided by Congress, the courts, or the state legislatures.

Congress could expand the scope of the SEC's control to include all proxy solicitations of public issue corporations. The inherent limitation in this approach, however, is Congress' power to regulate only interstate commerce or businesses affecting interstate commerce.<sup>80</sup> At present this constitutional restraint on the power of the SEC allows a substantial number of corporations to escape the supervision of the Commission under the claim of purely local commerce.

The state courts should give great weight to the Proxy

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78. *Id.* at 725. Other federal courts in diversity cases have likewise refused to follow the federal proxy rules when dealing with non-SEC regulated corporations. In *Western Oil Fields, Inc. v. McNab*, 232 F. Supp. 162, 164 (D. Colo. 1964), the court declared that when an injunction is sought under state law, a stronger showing of fraud must be made than that required under the SEC rules. In *Federal Home Loan Bank v. Greater Del. Val. Fed. Sav. & L. Ass'n.*, 277 F.2d 437, 439-40 (3rd Cir. 1960), the court could not be persuaded to apply the SEC rules to a non-SEC regulated corporation.

79. 248 F. Supp. 380, 384-85 (W.D. Pa. 1965).

80. U.S. Const. art. I, § 8.



Rules of the SEC when assessing the adequacy of disclosure in a particular solicitation case. These rules would provide the courts with clear, functional standards with which to evaluate solicitation materials and procedures. The drawback to relying solely on the judiciary for investor protection is that judicial action is remedial in nature and operates only on an ad hoc basis. What is needed in this instance is a uniform system of shareholder protection that is designed to prevent the effective disenfranchisement of shareholders by abuse of the proxy system.

It is therefore incumbent upon the state legislatures to establish a uniform system of proxy solicitation rules. These regulations are best patterned after, if not made identical to, the federal proxy rules, for the federal rules represent the combined knowledge of securities regulation experts, the product of detailed research, and years of experience. The states cannot, of course, regulate beyond their respective boundaries; thus a nationwide uniform system is required. The advantage in relying on the states as opposed to the federal government is the ability to regulate wholly intrastate commerce. The states should provide that compliance with the SEC regulations is automatic compliance with the state rules, so that overlap with the federal regulatory system would pose no problem. The net effect of this type of dual plan is the protection of all investors in any size public issue corporation, whether engaged in interstate commerce or not.

MARGARET BARR BRUEMMER